

ISDA

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
United States of America
Telephone: (212) 901 6000
Facsimile: (212) 901 6001
email: isda@isda.org
website: www.isda.org

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Robert H. Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

Dear Mr. Herz:

In conjunction with the FASB's decision to add a project to its agenda to address the issues that led to the "Staff Interim Guidance" in Statement 133 Implementation Issue No. D1, *Application of Statement 133 to Beneficial Interests in Securitized Financial Assets*, and the finalization of IASB Statement No. 39, *Financial Instruments: Recognition and Measurement*, the International Swaps and Derivatives Association (ISDA) would like to take this opportunity to provide brief comments relating to the accounting for hybrid instruments requiring bifurcation under paragraph 12 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (referred to as "hybrid instruments" for purposes of this letter). We believe that addressing the accounting for such hybrid instruments is also relevant given the Board's convergence and fair value objectives. We recognize that these comments are unsolicited; however, we believe that the nature and importance of the issue at hand merits consideration. We hope you find the comments informative and beneficial.

ISDA members represent leading participants in the privately negotiated derivatives industry and include most of the world's major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Collectively, the membership of ISDA has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments and specifically derivative financial instruments.

Background

Hybrid instruments (typically referred to in the market as structured notes) are designed to provide investors with market-driven exposure that is similar to that found in freestanding derivative instruments. Common marketplace examples of such hybrid instruments include equity-linked notes and credit-linked notes:

- An equity-linked note is a note for which the return of interest, principal, or both is tied to a specific equity security (other than that of the issuer) or equity index; it is essentially a bond combined with an equity derivative.
- A credit-linked note is a note where principal repayment is referenced to a third party's credit or external credit event; it is essentially a bond combined with a credit derivative.

The scope of this letter and ISDA's recommendation is restricted to hybrid instruments requiring bifurcation under Statement 133, thus notes indexed to other market risks such as foreign exchange rates, commodity prices and interest rate indices are also included within the scope of ISDA's recommendation to the extent that they would be required to be bifurcated in accordance with Statement 133.

Recommendation

ISDA supports allowing optional fair value measurement with changes in fair value recorded in earnings for hybrid instruments. Our basis for this recommendation follows and is consistent with that given in our July 1, 2002 comment letter relating to the Amendment of Statement 133 on Derivative Instruments and Hedging Activities. We believe that permitting such hybrid instruments to be measured in their entirety at fair value is warranted based on: (1) the original intent of Statement 133 and cost benefit considerations, (2) consistency with the business purpose and intent of the transaction, (3) convergence with International Accounting Standards, and (4) a fair value measurement objective.

Original intent of FAS 133 and cost benefit considerations

In the 1996 Exposure Draft, *Accounting for Derivative and Similar Instruments and for Hedging Activities*, the Board concluded that "certain financial instruments with embedded derivatives that cause the financial instrument to have characteristics similar to derivatives" should be measured at fair value like a derivative. The Board explicitly included structured notes (defined as hybrid instruments for purposes of this letter) as instruments to be measured at fair value. The Board stated that the accounting for such instruments should be consistent with that of a freestanding derivative. The Board supported a fair value measurement for freestanding derivatives and hybrid instruments because it was consistent with its belief that fair value is the most relevant for financial instruments and the only relevant measure for derivatives. The Board also believed that measuring hybrid instruments at fair value would improve transparency.

ISDA believes that for the reasons originally given by the Board, a fair value measurement for hybrid instruments is appropriate for initial recognition and subsequent measurement. In addition, allowing hybrid instruments to be measured at fair value in their entirety with changes recorded in earnings eliminates the operational burden of separating embedded derivatives. The cost introduced by requiring bifurcation is significant and requires substantial system and operational upkeep. In this case, the incremental costs provide little benefit as the bifurcation generates financial reporting information that is less relevant and less reliable.

Consistency with business purpose

Fair value accounting for hybrid instruments is appropriate given how the instruments are viewed and managed. These instruments differ from typical bond issuances in that they are trading instruments tailored to the diversification needs of the investor, not the funding needs of the issuer. From an operational perspective, these instruments are risk managed as part of the overall trading unit risk exposure similar to other derivative positions.

In addition, bifurcation is not necessarily representationally faithful to the underlying economics of the hybrid instrument because the hybrid instrument is priced and traded based on the unitary nature of the instrument and not the component parts recognized under current U.S. GAAP. The hybrid instruments are structured to closely reflect the underlying OTC derivative instrument's economic features.

Furthermore, the fair value of the unitary instrument is more readily available than the component parts recognized by U.S. GAAP. In many instances, prices for these instruments may be publicly available, either from an exchange or financial data providers such as Bloomberg or Reuters. Therefore, using a fair value measurement for hybrid instruments would lead to greater transparency and more relevant and reliable information for financial statement users.

Convergence with IAS

International harmonization of accounting standards would be enhanced if the FASB permitted the approach ISDA is currently recommending for hybrid instruments. IAS 39 permits entities to designate irrevocably on initial recognition any financial instrument as one to be measured at fair value with gains and losses recognized in profit or loss. Although the IASB is currently contemplating restricting the fair value treatment in IAS 39, the proposed revision will continue to permit fair value measurement upon initial recognition and subsequent measurement for financial assets or liabilities that contain one or more embedded derivatives and other financial instruments that meet certain criteria.

We support the IASB's assessment and conclusion regarding the use of fair value measurements for hybrid instruments and believe that the FASB's goal of international convergence provides further support for our recommendation.

Fair Value Measurement Objective

Our recommendation is consistent with the FASB's conclusion that fair value is the most relevant measure for financial instruments. The Board has previously stated that it believes that fair values for financial instruments provide more relevant and understandable information than cost or cost-based measures. Our recommendation is also consistent with the FASB's ultimate goal of fair value measurement for all assets and liabilities. The Board indicated in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, that information about fair value better enables investors, creditors, and other users to assess the consequences of an entity's investment and financing strategies. In addition, allowing a fair value measurement mitigates problems arising from a mixed

attribute model when assets are measured at fair value and related liabilities are measured at amortized cost.

Conclusion

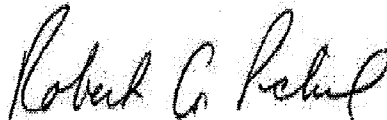
ISDA recommends allowing optional fair value measurement with changes in fair value recorded in earnings for hybrid instruments that otherwise would be bifurcated under Statement 133. These hybrid instruments would be presented on the balance sheet in their entirety in a manner consistent with how the host contract of a currently bifurcated hybrid instrument is presented (i.e., as debt) and the upfront cash flows associated with such instruments would be classified in accordance with the provisions of FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. In addition, disclosures would further clarify how a company accounts for and presents the instruments.

Should you have any questions or desire any clarification concerning the instruments referred to or matters addressed in this letter, please do not hesitate to contact any of the undersigned at the telephone numbers provided.

Sincerely,



Shannon Warren
J.P. Morgan Chase & Co.
212.648.0906
Chair, Accounting Policy Committee
International Swaps and Derivatives Association



Robert G. Pickel
Director and CEO
International Swaps and Derivatives Association
212.901.6020

Cc: Donald T. Nicolaisen
Chief Accountant
Securities and Exchange Commission